Compliance Corner

Toeing the Line: Compliance with Exemptive Orders and Other Authorities

By: Lorna A. Schnase*

In May 2013, the SEC Division of Investment Management issued an IM Guidance Update (No. 2013-02) ("Update") (*available at* http://www.sec.gov/divisions/investment/guidance/im-guidance-2013-02.pdf) indicating that, in some cases, firms have failed to 'toe the line' with respect to their Exemptive Orders by failing to comply with the representations, terms and conditions contained in the Orders. The Update sends a clear message to advisers: Stay in compliance with your Exemptive Orders or risk violating the federal securities laws.

This article discusses the Update, along with its broader implications for all advisers, including those not relying on Exemptive Orders.

What are the Key Take-Aways from the Update?

Using simple 1-2-3 logic, the Update says in substance—

1. Advisers are required to adopt compliance programs reasonably designed to prevent violations of the federal securities laws.

2. Advisers operating under Exemptive Orders risk the severe consequence of violating the federal securities laws from which the Orders grant an exemption if the adviser does not comply with the representations, terms and conditions necessary for the Orders to apply.

3. Advisers should take this risk into consideration in designing their compliance programs. One way would be to implement procedures aimed at ensuring ongoing compliance with each representation, term and condition of their Orders.

What Else Has the SEC Staff Said About Exemptive Orders Recently?

In addition to being the focus of the Update, compliance with Exemptive Orders was also listed as a focus area in the Examination Priorities published by the SEC's Office of Compliance Inspections and Examinations (OCIE) in February 2013. Indeed, the priorities list may have been OCIE's "shot across the bow" warning advisers about the inspection focus that ultimately led to the Update.

Why is the Update Important Even for Advisers Not Operating Under Exemptive Orders?

Although the Update focuses on Exemptive Orders, Exemptive Orders are not the only authorities on which advisers rely that contain terms or conditions necessary for the authority to apply. Many other types of authorities contain similar terms and conditions, such as regulatory exceptions, no-action letters, settlement orders, informal SEC staff guidance, FAQs and the like. A few examples are highlighted below:

- **Regulatory exceptions and parameters—Examples:**

  - The exception that allows certain uncertificated privately offered securities to not be held by a qualified custodian under the adviser custody rule (Rule 206(4)-2) is available to pooled vehicles only on the condition that the pool is audited and the audited financial statements are distributed to investors in accordance with the rule.

  - The only adviser personnel that may rely on Rule 3a4-1 of the Securities Exchange Act of 1934 to avoid being deemed a broker-dealer in connection with fund share sales are those that meet at least one of the three conditions spelled out in subsection (a)(4) of that rule (restricting participation in fund

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share transactions, for example).

- Family offices are excluded from the definition of investment adviser under Advisers Act Rule 202(a)(11)(G)-1 only if they meet three general conditions contained in the rule (limiting their structure and scope of activities).

- Advisers often provide representations or undertakings to the SEC staff when responding to deficiency letters, for example, to change procedures, make disclosures, take particular steps or the like.

- **No-action letters (no matter who they are issued to)—Examples:**

  - Advisers that choose to advertise their performance may so do only under certain conditions, including avoiding inappropriate practices that may render the ad false or misleading, as spelled out in the Clover Capital Management, Inc. no-action letter (October 28, 1986) and its progeny.

  - Special purpose vehicles (SPVs) created by a registered adviser are not required to register separately as investment advisers with the SEC provided that the conditions spelled out in the no-action letter issued to the ABA Subcommittee on Private Investment Entities (December 8, 2005) and/or the ABA Business Law Section (January 18, 2012) are met (having to do with the formation and operation of the SPV).

- **Settlement orders—Example:**

  - Orders settling SEC enforcement actions often include conditions, stipulations or undertakings with which the respondent adviser is required to comply, such as hiring an independent consultant and instituting the consultant's recommendations, sending specified notices to clients, posting disclosures on the adviser's website and so on.

- **Undertakings provided during registration—Examples:**

  - Multi-state advisers (those that register with the SEC in lieu of having to register with 15 or more states) undertake on Form ADV to withdraw from SEC registration if a future ADV amendment indicates they would be required to register with fewer than 15 states.

  - Newly formed advisers filing Form ADV in anticipation of SEC eligibility within 120 days undertake to withdraw their SEC registration if they are not SEC-eligible within that time period.

  - Non-resident advisers are excepted under Rule 204-2(j)(3) from maintaining certain books and records in the U.S. if in connection with their registration they provide the SEC with an undertaking to furnish those records upon demand.

- **Other requirements—Examples:**

  - Similar representations, terms and conditions are often imposed by other regulators (such as the Department of Labor for ERISA accounts, state regulators for advisers registered with the states and the CFTC for advisers subject to regulation under the commodity laws) or the laws of other countries (for advisers doing business in, registered in or advising clients abroad).

As a result, even advisers that do not operate under Exemptive Orders should heed the broader message of the Update that the consequences can be severe if they do not comply with the terms or conditions underlying the authorities on which they rely to conduct business. Advisers should therefore consider these risks in the design of their compliance program.

How is this Different from Merely Complying with Applicable Statutes and Rules, Which Advisers Must Do Routinely Every Day?

In some respects, it's not different. To remain in compliance with the law, advisers must adhere to their Exemptive Orders and other authorities just like the statutes and rules they must adhere to every day. However, the terms underlying an Exemptive Order or other authority are different than everyday statutes and rules in two important ways—

First, the underlying terms are less "front and center" and are therefore more susceptible to being overlooked or forgotten altogether. They may be contained, for example, in:

- Exemptive Orders that may have been granted to the adviser years ago, before key personnel currently at the adviser were even employed there, or
- no-action letters that may form the basis for internal practices in effect at the adviser for years, which have perhaps been altered or even terminated over time without careful consideration of why those practices were instituted in the first place, or
- exceptions (or exceptions to exceptions) to the usual rules, which may not be widely cited, discussed or understood.

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Second, the terms underlying Exemptive Orders and other authorities are not themselves legal requirements. In effect they are prerequisites necessary for certain legal consequences to flow, for example, for an exemption, no-action position or exception to apply. Being once or twice removed, then, from the actual legal requirements makes the underlying terms and conditions even more susceptible to being overlooked.

What Other Aspects of the Update Should Advisers Consider?

Advisers should also consider that the message in the Update applies not only to the adviser, but to the adviser's service providers as well, such as its custodians, proxy voting firms, pricing agents and fund administrators, to name just a few. When vetting service providers, then, cautious advisers will consider whether the provider is relying on Exemptive Orders, no-action letters, regulatory exceptions or other authorities to conduct its business and seek assurances that the provider is in compliance with any necessary terms and conditions.

Similarly, advisers should consider Exemptive Orders and other authority granted to issuers in which the adviser's clients are invested, as they too may contain terms or conditions necessary for the client to rely on that authority. For example, ETFs often obtain Exemptive Orders that allow funds investing in the ETF to exceed the otherwise applicable investment limits under Section 12 of the Investment Company Act of 1940. A common condition imposed by these Orders is that the investing funds enter into a participation agreement with the ETF containing certain provisions, including that the investing fund's Board and adviser agree to fulfill their responsibilities under the Order, that the investing fund transmits to the ETF a list of certain of its affiliates and that the investing fund maintains copies of certain documents for the duration of the investment and for at least six years thereafter. Therefore, if an adviser's fund clients are investing in ETFs beyond the statutory limits in reliance on an Exemptive Order issued to the ETF, steps should be taken to ensure that the funds enter into the necessary participation agreement and meet all the other conditions necessary for the Order to apply. Otherwise Section 12 violations could result.

What Should Advisers Do in Light of the Update?

Wise advisers will consider the Update as it applies to them, as well as the broader implications that go beyond Exemptive Orders and beyond the adviser. Here is a sample list of suggested action items advisers might follow toward that end:

1. **Exemptive Orders/Other Requirements for the Adviser**
   a. Identify and list any Exemptive Orders or other requirements (such as no-action letters, settlement orders, registration undertakings and so on) that apply to the adviser and any related representations, terms or conditions.
   b. Check to confirm that the adviser is in compliance with any items identified.
   c. Document the process.

2. **Exemptive Orders/Other Requirements for Service Providers**
   a. Ask service providers to certify to the adviser that they have undertaken a similar process for themselves, whether in response to the Update or as part of their routine risk management.
   b. Spot check service provider documentation of this process as part of the adviser's on-going oversight and monitoring.

3. **Exemptive Orders for Issuers (such as ETFs)**
   a. Consider whether any of the adviser's fund clients are invested in ETFs or other funds in reliance on Exemptive Orders granted to the issuers.
   b. If so, take appropriate steps to confirm that any necessary terms and conditions of the Orders are being met.

4. **Consider Revisions to Compliance Policies and Procedures**
   a. Consider whether revisions to the adviser's compliance policies and procedures should be made in light of the representations, terms and conditions identified in the earlier steps.
   b. Even if revisions are not warranted, consider whether Exemptive Orders or other requirements should be added to the adviser's risk inventory or risk matrix, so that appropriate consideration will be given to these matters at least annually, even in the absence of specific procedures.
   c. Consider the same with respect to the policies and procedures of the adviser's service providers.

5. **Reporting and Management Oversight—Steps for the Chief Compliance Officer (CCO) to Consider**
   a. Report the IM Guidance Update to senior management as part of any regular legal and regulatory developments report.
   b. Report to management actions taken and results found in accomplishing the prior steps.
   c. Report to management any revisions to policies and procedures recommended as a result.
   d. Explain to management how the Update and related considerations will be worked into the compliance process on an ongoing and/or annual basis.

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e. Get management's sign-off on how on-going CCO reporting of these items will occur (for example, as an item on the routine quarterly Compliance Committee agenda or as an Annual Review item included in the CCO's Annual Compliance Review Report, if prepared.)

f. Consider whether reporting to other oversight bodies (for example, fund Boards or a Risk Committee) should be undertaken along the same lines.

These items are suggestions only. They are not regulatorily required nor are they necessarily sufficient for every adviser. Advisers may find that the list should be modified once they are in the process of addressing individual items. As with most compliance-related measures, it would be best if these considerations were worked into the adviser's on-going and/or annual compliance process so that any year-to-year changes can be identified and addressed appropriately.

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The SEC's Update on Exemptive Orders conveys a simple message: The consequences can be severe if an adviser fails to 'toe the line' and stay in compliance with the terms and conditions of its Exemptive Orders. However, even advisers not relying on Exemptive Orders should heed that message because it applies more broadly to other types of authorities on which advisers often rely, such as regulatory exceptions, no-action letters, settlement orders and the like. The message also applies to an adviser's service providers, in addition to the adviser, which should be kept in mind when advisers vet and monitor providers. Following the action items list spelled out in this article is one way advisers might consider the Update as it applies to them, along with these broader implications.

** Lorna A. Schnase is an investment management lawyer focusing her practice on matters under the Investment Advisers Act of 1940 and the Investment Company Act of 1940, primarily for registered adviser and fund clients. This information is provided strictly as a courtesy to readers for educational purposes. All facts and matters reflected in this article should be independently verified and should not be taken as a substitute for individualized legal advice.* ■

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The IAA is pleased to introduce the following new member firms that have joined our Association. This list of new members includes those firms that have joined since our last acknowledgement in the September 2013 *IAA Newsletter:*

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Endurance Wealth Management, Inc. – Providence, RI
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